Associated Bank

INTEREST RATE UPDATE

Capital Markets Department
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ENDGAME OR REBOOT?

Fans of the Marvel Cinematic Universe are eagerly anticipating release of *Avengers: Endgame*, the final film in Marvel Studio's 22-movie superhero franchise that began in 2008. And just like investors and business folks who have been watching the economy's sustained recovery since the 2008 financial crisis, these fans are furiously trying to guess how this movie will end. Will the "good guys" of sustainable growth win, allowing the expansion to continue beyond its ten year anniversary in June, or will we again have to battle recession and job loss in the coming year? The economic data is showing as many twists and turns as in the plot of *Captain Marvel* or *Ant-Man* (for non-MCU fans, yes, that's a real movie).

- Interest rates continued the broad downward trend we have seen since November 2018. Ten year Treasury yields fell from a high of 3.24 percent to a trough of 2.37 percent at the end of March, rebounding to 2.50 percent this week as concerns over global growth and a slowing U.S. economy shifted investor expectation toward a looser monetary policy.

- The yield curve inverted briefly late last month as the spread between the ten year Treasury yield and the three month T-bill rate dropped into negative territory. This has since reversed, but the curve remains very flat, suggesting that the slowing economy will now keep the Federal Reserve (Fed) on the sidelines. As expected, the Fed opted to leave rates unchanged at their March meeting, and markets are now pricing in at least one rate cut by the end of 2019.

- Monthly job growth rebounded to 198,000 in March, after a disappointing 33,000 increase in February. The unemployment rate remains at 3.8 percent while average hourly earnings growth softened to 3.2 percent. The Federal Reserve Bank of New York's survey of consumer expectations reflected a solid job market as anticipated wage growth and job stability remained sound. Meanwhile, total consumer credit expanded 4.5 percent, driven especially by auto and student debt.

- Consumers also anticipate 2.8 percent inflation - significantly higher than the current CPI level of 1.5 percent or the 1.85 percent priced into today's TIPS breakeven rates.

The Trump Administration introduced two new "characters" to the monetary policy debate but the trial balloons have not been well received by investors. Stephen Moore of the Heritage Foundation and former presidential candidate Herman Cain were floated for two open seats on the Fed Board of Governors. Both men have inconsistent and untested monetary policy views that have shifted with the political winds, which could put the Fed's credibility at risk. Their confirmation is not a foregone conclusion.

Markets have priced in the expectation that the Fed is at the "Endgame" of the current rate cycle, reflected in current low two year rates, low inflation premiums in the market, and a flat yield curve. This means that companies with capital projects in the works can take advantage of forward rate locks, attractive long term financing, cancellable swaps and other hedging alternatives. Recall, however, that the Fed still anticipates one or two more rate hikes that are not priced into the market. If economic data comes in stronger than expected, we could "reboot" to a no-recession scenario. As we saw in late 2018, a stronger growth trajectory could prompt a significant upward shift in interest rates.

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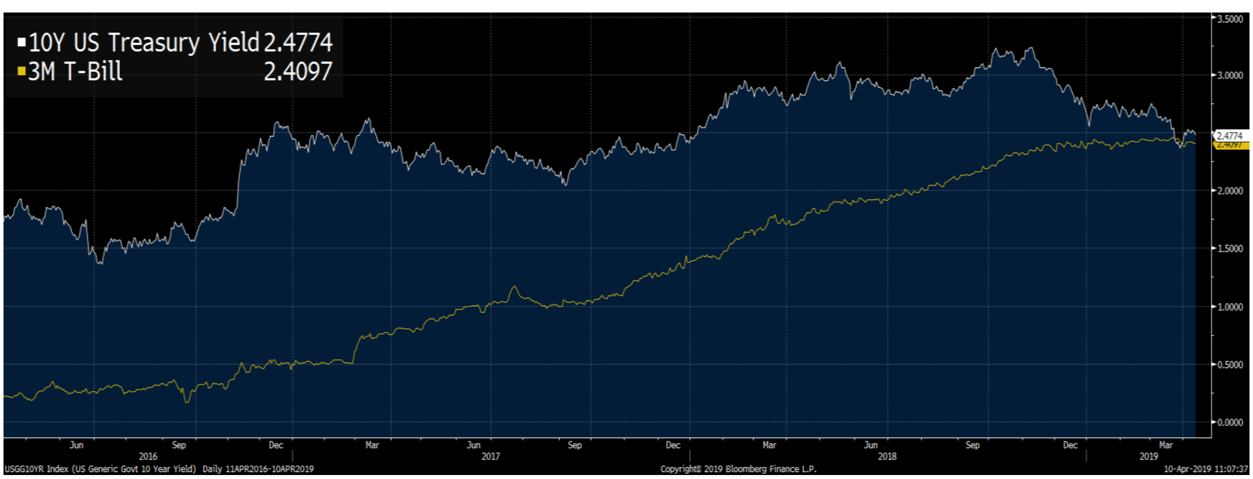
Key Statistics: Interest Rates, Unemployment and Inflation

	Year-end 2015	Year-end 2016	Year-end 2017	Year-end 2018	CURRENT Apr 10, 2019
10 yr Treasury yield	2.27%	2.44%	2.41%	2.68%	2.47%
2 yr Treasury yield	1.05%	1.19%	1.88%	2.49%	2.32%
Spread	1.22%	1.25%	0.53%	0.19%	0.15%
Fed Funds Target (mid)	0.375%	0.625%	1.375%	2.375%	2.375%
1m LIBOR	0.43%	0.77%	1.565	2.50%	2.48%
SOFR	NA	NA	NA	3.00%	2.46%
CPI (y/y change)	0.50%	1.70%	2.20%	2.20%	1.50%
Core PCE (monthly)	1.33%	1.65%	1.50%	1.50%	1.79%
TIPS (market breakeven)	1.28%	1.87%	1.88%	1.49%	1.85%
U-3 Unemployment	5.0%	4.7%	4.1%	3.9%	3.8%
Avg weekly earnings (chg)	2.5%	2.7%	2.7%	3.3%	3.2%
Annual change in NFP jobs	2.744,000	2,157,000	2,188,00	2,513,000	2,537,000

10 Year Treasury Yield vs 3 Month T-Bill, *past three years*



Source: Bloomberg LP

- The benchmark ten year U.S. Treasury yield has dropped 75 basis points since November, reflecting slower global growth, low inflation and a more dovish tone from the Federal Reserve.
- At the short end of the curve, three month T-bills have taken a pause after a steady rise over the past three years.

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The Consumer Price Index (CPI) has averaged 1.5 percent over the past five years. The average since early 2016 has been exactly at the Fed's 2.0 percent target, though this has softened lately. Market expectations for 5 year inflation (green line) have remained "well anchored" in central bank parlance.

The Purchasing Managers Index for manufacturing currently sits at 55.3, near its five year average. While this remains above the 50 level which indicates expansion, this diffusion index has softened in 2019. The comparable services index is slightly higher, and held up better through the oil equipment downturn in 2015.

The unemployment rate, which has been falling since 2010, bottomed out in September 2018 and has essentially been treading water for the past year. With the economy at full employment, we are unlikely to see significant improvement below the current level of 3.8 percent.

Data on interest rates and economic indicators were obtained from Bloomberg, LP. Consumer survey data from the Federal Reserve Bank of New York.

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